PERSONAL FINANCIAL SERVICES SINCE 2001

What is ESG investing?

ESG investing is one of the fastest growing trends in finance over the past few years. ESG stands for Environmental, Social, and Governance and is an evolution of socially responsible investing. ESG investing is an investment strategy that seeks to integrate environmental, social, and governance considerations into an investor's decision-making process. ESG investing also seeks long-term financial returns through managing risks and identifying opportunities.

The type of considerations that a fund manager would look at as part of its ESG analysis from an environmental perspective could be climate change, waste and pollution. Social considerations could include modern slavery and human rights, and governance considerations could include board diversity and executive remuneration.

What ESG investing seeks to do is to invest in companies that have strong sustainability characteristics and look after all its stakeholders. It is important to note that ESG investing is not just an investment strategy, it's also a way to have a positive impact on the world.

Why is ESG investing growing in popularity?

There are generally four key drivers behind the rising popularity of ESG investing.

Firstly, there is a growing awareness regarding the impact of external factors such as climate change and supply chain issues. After many years of foundational efforts to standardise and enable sustainable investing, the COVID-19 pandemic has focused investors on the vulnerability and resilience of the financial system and intensified discussions around sustainability.

Secondly, outperforming returns. According to Morgan Stanley Institute for Sustainable Investing, sustainable funds outperform traditional peer funds and reduced investment risk during coronavirus in 2020[1]. It is believed that there is a positive relationship between a company's relative market performance and its sustainability rating. This is attributable to the idea that a company focused on sustainability issues is an indication of a quality Board and business management practices.

Thirdly, resilience. Companies that operate with high standards of sustainability are likely to be resilient during uncertain times. They could perform better in areas such as customer relations, supply chain, sustainability, and culture. They could also be more resistant to threats caused by governance and sustainability issues.

Lastly, regulation. Globally many countries are starting to develop policies focused on sustainability. Some jurisdictions have started to introduce legislations designed to address key ESG issues. For example, Australia introduced the *Modern Slavery Act 2018*[1], which requires certain companies to report on modern slavery risks in their supply chains.

ESG metrics

ESG metrics are used to assess a company's exposure to a range of environmental, social and governance risks. The use of ESG metrics in investment analysis can help investors such as fund managers to understand a company's exposure to ESG risk. However, there is no standardised approach to the calculation or presentation of different ESG metrics.

You can apply a variety of analytical approaches to ESG and not all ESG topics are given equal weight by a company. Just as every investor in the market has different values and motivations, it is unlikely that an organisation will prioritise all ESG issues in their business strategy.

A broad scope of ESG metrics are outlined below:

Environmental

Conservation of the natural world

- Biodiversity
- Climate change
- Carbon footprint
- Deforestation
- Greenhouse gas (GHG) emissions
- Recycling
- Resource depletion
- Waste and pollution
- Water and energy efficiency

[1]Morgan Stanley, Sustainable Funds Outperform Peers in 2020 During Coronavirus, available at https://www.morganstanley.com/ideas/esg-funds-outperform-peers-coronavirus

Social

Consideration of people & relationships

- Child labour and slavery
- Community engagement
- Employee diversity, treatment, and compensation
- Equal opportunities
- Ethical supply chain sourcing
- Health and safety
- Human rights
- Philanthropy
- Working conditions

Governance

Standards for running a company

- Board diversity and structure
- Bribery and corruption
- Business ethics
- Compliance
- Executive remuneration
- Political lobbying and donations
- Tax strategy
- Whistleblowing schemes

How can I incorporate ESG investing into my portfolio?

There are many different ways to incorporate an ESG philosophy into your investment portfolio. For instance, you could invest into shares of companies that you believe fit into your criteria of sustainability and ethics.

However, not many investors have the knowledge and resources to perform the research to pick their own stocks. An easy way to gain exposure to ESG investing is to utilise ESG funds – managed funds and exchange traded funds that are purpose-made to invest in companies or other investments that fit an ESG criteria. Portfolio managers of ESG funds will only include companies that comply with ESG principles in their portfolio. If this interests you, we suggest you talk to your financial adviser about incorporating ESG funds into your investment portfolio.

What approaches do fund managers undertake to apply ESG investing?

When an investment universe is assessed for ESG attributes, the fund manager will primarily screen the constituents to narrow down the companies that can be invested in. To do this several filters or screens will be applied, which may be unique to each fund manager depending on how they regard ESG factors.

Negative screening is the process whereby some industries or companies may be excluded, typically this includes companies that generate revenue from tobacco, gambling, armaments or adult entertainment. Companies that generate revenue from other activities such as junk food, genetic engineering or logging may also be screened out. Depending on the investor's belief, they will either apply a hard screen, where an industry or company cannot be invested in at all, or exclude if a company generates more than 10% of revenue from the negative sectors.

Positive screening occurs when a fund manager is looking for companies in the industries that they believe they would like to invest in from an ESG perspective, such as renewable energy, wind and solar farms.

Thematic investing is where an investor is looking to invest in a specific theme or trend, rather than specific companies. In the context of ESG, this could equate to investing in trends such as sustainable farming, clean technology or health.

Impact investing is where an investment is able to generate not only a financial reward for its investors, but importantly, a measurable social and environmental benefit. For example, an impact investment is investing in affordable housing.

Overall, the goal of the fund manager is to ensure that the companies they are investing in align to their ESG beliefs and the outcome they are looking to achieve. To reiterate each ESG investment vehicle will have its own specific definition of what ESG means to them, what factors they want to invest in and what attributes they are looking for when investing in a sector or company.

Your financial adviser will be able to recommend ESG fund managers that are suitable to your needs.

Common ESG investing terms

Active ownership

A form of stewardship whereby shareholder power is used to influence corporate behaviour through direct corporate engagement, filing or co-filing shareholder proposals, and proxy voting guided by comprehensive ESG guidelines.

ESG

Environmental, Social and Governance – the three central factors/ criteria used by responsible investors to screen and select companies and other investments for their portfolios.

ESG integration

The systematic and explicit identification and inclusion of material ESG factors into investment analysis and investment decisions.

Norms based investing

An approach that excludes investments based on not complying with international standards of conduct, such as the United Nations Universal Declaration of Human Rights.

Screening

An investment approach which specifically filters companies based on their involvement in either beneficial (positive) or undesirable (negative) activities.

Stewardship

The responsible allocation, management and oversight of capital to create long-term value for clients and beneficiaries, leading to sustainable benefits for the economy, the environment and society.

Principles for Responsible Investment

An UN-supported body regarded as the world's leading proponent of responsible investment. It has issued a set of voluntary and aspirational investment principles that all signatories must commit to.

Values-based investing

An investment approach that excludes investments based on ethical, values-based or religious criteria, for example, gambling, alcohol, or pork.

If you are interested or want to learn more about ESG investing, please speak to your financial adviser.